

**REDUCING THE RESERVES OF
THE FEDERAL EMPLOYEES
HEALTH BENEFIT PROGRAM**

Staff Working Paper

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**REDUCING RESERVES OF THE FEDERAL
EMPLOYEES HEALTH BENEFITS PROGRAM**

**The Congress of the United States
Congressional Budget Office**

PREFACE

The large accumulation of reserves of the Federal Employees Health Benefits program (FEHB) has given rise to concern about the necessity of current reserve levels, the manner in which they are held, and the most appropriate way to dispose of excess funds. This study, undertaken at the request of the House Committee on Post Office and Civil Service, addresses these questions and poses several alternatives to current policy on the FEHB reserve system.

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SUMMARY

In setting annual premium rates for the Federal Employees Health Benefits (FEHB) program, the Office of Personnel Management (OPM) and the more than 80 insurance carriers with which it does business negotiate program income that covers costs and overhead, and that usually yields some surplus. The surplus, held partly by the government in individual "contingency reserves" earmarked for each carrier and partly by each carrier in "special reserves," is intended to serve as a hedge against unforeseen adverse cost fluctuations in the contract year. Aside from how they are held, the two types of reserves differ little.

Over the past decade, the FEHB program's reserves have increased about fourfold, reaching \$490 million in 1980, or 15 percent of the year's income from premiums; OPM guidelines specify reserve levels of about 14 percent. This growth, partly resulting from overestimates of program costs used in annual rate setting, has drawn attention to three questions:

- o What level of FEHB reserves is necessary?
- o How should reserve holdings be allocated? and
- o By what means should reserve excesses be disposed of?

Reserve Levels

Although holding reserves is a generally accepted way to hedge against future cost variations, no specific level of reserves for FEHB has ever been agreed on. The current practice is to tailor reserve sizes to particular plans, allowing relatively larger reserves for smaller plans, which may have less nonfederal capital to draw on and smaller pools of enrollees among whom to spread risk. Overall reserve levels for the FEHB program as a whole have averaged 19 percent of premium income throughout the past decade. Analyses by various agencies, including the Congressional Budget Office and General Accounting Office, however, suggest that an overall reserve level as low as 6 percent of premium income might well be adequate.

Allocation of Reserves

At present, some 20 percent of FEHB program reserves rests with the participating carriers, and according to the Administration's projections, the carrier-held share will decline to around 13 percent over the next five year. Allowing carriers to hold reserves, however, conflicts with governmental financial management objectives that would prevent nonfederal entities from holding federal cash balances. Indeed, there is little reason for carriers to hold any part of the FEHB reserves. All FEHB reserves could be held by the government, specifically by the U.S. Treasury.

Disposition of Excess Reserves

If overall FEHB reserve levels are to be brought down, a way must be found for disposing of the excess money. Several approaches could be considered. Under current practice, excess accumulations are used over two or three years to defray future premium rate increases. Drawing down all excesses in the next contract year instead would improve equity, because enrollees whose premiums helped create a surplus would more likely be the same enrollees to benefit from its use. Excess reserves could also be disposed of through rebates or through additional benefits. Rebates would be the most equitable approach, but they could increase program overhead and encounter administrative problems. Using excesses for additional benefits could ultimately be more costly than other methods, unless the new benefits were cancelled when the excess was exhausted.

OPTIONS FOR CHANGING THE LEVEL AND ALLOCATION OF RESERVES

In response to the above concerns about FEHB reserves, three options for change are outlined below. Over the next five years, each would reduce total reserve accumulations--by 30 percent under Options I and II and by 70 percent under Option III--below levels now projected by the Administration. Excess reserves would defray future FEHB premium increases by as much as \$1.09 billion through 1986. Two of the alternatives, Options II and III, would also transfer all carrier-held reserves to the federal government.

Contrary to what might seem obvious, using excess reserves to defray premium rate increases would increase five-year budgetary

outlays. This would occur because reduced premiums would decrease program income from enrollees and from off-budget agencies, which contribute to the program. Premiums from on-budget agencies represent internal budget transactions that do not affect total federal budget outlays. The additional outlays, however, could be partly offset if the special reserves now held by carriers were transferred to the federal government. Cumulative net outlay increases estimated for each option reflect these impacts and represent changes from the Administration's budget projections through 1986.

Option I. Limit Reserve Accumulations to Present OPM Guidelines and Require Disposal of Excess Reserves in Next Contract Year

Option I would limit total reserve accumulations to the 14 percent of premium income specified in OPM guidelines. Excess reserves under this plan would be used to defray rate increases during calendar year 1982, the next contract year, rather than over two or three years. The lower reserve levels would reduce premium income by some \$540 million over five years, of which \$230 million would benefit enrollees at an average of \$12 per enrollee for each year. Five-year outlays under this approach would increase by \$190 million.

Option II. Limit Reserve Accumulations to OPM Guidelines, Require Disposal of Excess Reserves in Next Contract Year, and Have the Federal Government Hold All Reserves

Option II would impose the same reserve levels as Option I, thus achieving the same premium reduction. But in addition, it would transfer carrier-held reserves to the federal government. This transfer, phased in over three years, would bring FEHB into conformance with federal financial management objectives and would thus result in outlay increases of only \$85 million.

Option III. Impose Lower Reserve Limitations, Require Disposal of Excess Reserves in Next Contract Year, and Have the Federal Government Hold All Reserves

Like Option II, this approach would transfer carrier-held reserves to the federal government. But, consistent with various

analyses, it would restrict reserves to much lower levels. Cumulative reserves for all FEHB plans would average about 6 percent of premium income instead of the recent 15, with levels for particular plans still determined by plan size. The option also permits short-term Treasury borrowing by FEHB to backstop any shortfalls brought about by underfunding. The lower reserve levels would reduce premiums by \$1.09 billion through 1986--about double Option I and II reductions--and increase outlays by \$375 million. Of the total premium reduction, about \$455 would benefit enrollees at an average annual savings of \$23 per enrollee for the five years after implementation.

REDUCING RESERVES OF THE FEDERAL
EMPLOYEES HEALTH BENEFITS PROGRAM

CHAPTER I. OVERVIEW OF THE FEHB PROGRAM AND ITS RESERVES

The Federal Employees Health Benefits (FEHB) program, which provides health-care coverage for some 2.4 million active federal government workers and another 1.2 million retirees, is designed to yield a surplus of income each year. ^{1/} In the past decade, FEHB surpluses, held in reserve accounts, have increased from \$126 million to \$490 million in 1980. The accumulation of large reserves has given rise to several concerns--specifically, whether current reserve levels are excessive, whether the manner in which they are held is appropriate, and what is the most appropriate way to dispose of excess funds. In response to these concerns, this study considers the following three questions:

- o How large a reserve is necessary?
- o What parties should hold the reserve? and
- o How should the excess be eliminated?

The remainder of this chapter gives an overview of the FEHB program, including the rationale for maintaining reserves. The second chapter examines FEHB reserve issues. The closing chapter outlines several options for changing FEHB reserve policy.

HOW THE SYSTEM OPERATES

As administrator of the FEHB program, the Office of Personnel Management (OPM) contracts with more than 80 insurance carriers to provide health-care coverage for active and retired federal civilian workers (referred to as enrollees). OPM manages the transfer of FEHB payments through a trust fund (described later in this chapter) and negotiates yearly premium rates. Although the participating carriers bear financial risk in the event of plan termination, they serve mainly as claims processors--managing money that is essentially federal.

^{1/} The FEHB program was established by Public Law 86-382, approved September 28, 1959.

Two carriers--Blue Cross/Blue Shield and Aetna Life Insurance Company--offer government-wide plans; together, they account for about two-thirds of all FEHB coverage. Other plans are provided by employee organizations that offer health coverage to members and by local medical groups or individual physicians that offer coverage in certain areas. 2/ Because of their dominant position in the FEHB program, the Blue Cross/Blue Shield and Aetna plans provide the basis for most of the analysis in this study.

Enrollees and the government pay for FEHB premiums and associated costs, which currently total about \$4 billion. Employee and annuitant participation in FEHB is voluntary, but only 20 percent of all eligible workers elect not to enroll in the program. The enrollees' contributions are deducted from pay and retirement checks; the government's share is paid from individual agency appropriations. 3/ Income not used to pay benefits or overhead accumulates in reserves. These are held in part by the federal government (the so-called "contingency reserves," which are earmarked for each carrier) and in part by participating carriers (the "special reserves"). 4/

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- 2/ Appendix A summarizes operating data for FEHB plans. Most group and individual practice plans are community rated; that is, premium rates are based on the costs that prevail in the community in which the plan is based, rather than on the cost experience of federal enrollees. Reserves of community-rated plans are not addressed in this paper. These plans hold no reserves in their custody, and federal reserves earmarked for them make up about 4.4 percent of total FEHB program reserves.
- 3/ The allocation of FEHB costs between enrollees and the government as employer varies for particular groups: cost sharing averages 46/54 percent for nonpostal employees, 25/75 percent for postal workers, and 42/58 percent for annuitants.
- 4/ Participating organizations also maintain an accrued claims reserve for claims that have been submitted but not paid. Several studies of the accrued claims reserves held by the two government-wide plans have found them adequate; these reserves are not examined in this paper.

Primarily, the reserves provide a hedge against possible underestimates of the annual costs of claims. Both types of reserves, contingency and special, serve this purpose; they differ essentially in that they are held by different parties. Both reserves, and the interest they earn, can be used only for FEHB benefit claims and expenses. According to OPM requirements for the accumulation of reserves for individual plans, the levels targeted for contingency and special reserves combined average 14 percent of annual premium income (1 3/4 months) for the FEHB program as a whole. For the government-wide plans, the guidelines equate to reserves of 12.5 percent of a year's premium income (1 1/2 months). ^{5/} These reserve requirements, based on past experience and recommendations by consulting actuaries, are designed to maintain accumulated reserves at a constant percentage level. Thus, reserves in absolute dollar amounts increase in proportion to rising enrollment, prices, and use of health care. Other arrangements, however, such as extension of federal credit, might just as well provide a satisfactory safeguard against imperfect cost forecasting.

Premium rate negotiations begin each spring, and the rate arrived at applies during the following calendar, or "contract," year. The premiums OPM negotiates for each plan cover the contract year's expected benefit and overhead costs, including a service charge for participating carriers as remuneration for running their plans. ^{6/} When premium rates are set, consideration is also given to interest from invested capital, payments received by participating organizations from the contingency reserves held by OPM, and adjustments in the level of carrier-held special reserves. The agreed-upon rates are then raised by 1 percent to cover OPM's administrative expenses and by another 3 percent for payments into reserves for each individual carrier. (The 3 percent add-on is the maximum permitted by current law, and the rate could be lowered administratively without Congressional action.)

^{5/} The 12.5 percent guideline for government-wide plans includes federal contingency reserves of 8.3 percent of premium income and carrier-held special reserves of 4.2 percent of premium income. For other plans, special reserves vary.

^{6/} The service charge is usually fixed at a specified percent of premium income, ranging from 0.3 to 0.8 percent.

In negotiating rates, OPM often allows the combination of special and contingency reserves to deviate significantly from guideline targets. For example, combined reserves planned by OPM in 10 recent rate cases (1976-1980 for each of the two government-wide plans) ranged from 109 percent below to 162 percent above the reserve levels stipulated in OPM guidelines. OPM departs from the guidelines in order to defray rate increases in the upcoming contract year or to maintain a cushion for rate increases in future years. Negotiation during the five-year period 1976-1980 anticipated that about half of the annual reserves in excess of guidelines would be drawn down to avoid higher rate increases that would otherwise have accumulated to 4.7 percent. If all of the excesses had been drawn, however, cumulative rate increases of 10.2 percent would have been avoided.

A revolving federal trust fund account finances FEHB as an on-budget program. Premium payments from enrollees and agencies are deposited into the FEHB fund, and semimonthly payments to participating carriers are paid from it. In general, the number of plan participants times the negotiated rates (per enrollee) determines the size of the semimonthly payments to carriers. Annual outlays from the fund essentially represent the difference between income from enrollee and agency contributions and outgo for payments to participating carriers. Because a portion of the payments that pass through the FEHB fund are set aside as part of the program's reserves, income generally exceeds outgo; the program thus generates negative (minus) outlays in the fund. The effect on total budget outlays, however, is quite different: the cost to the carriers is offset by income from enrollees and off-budget agencies.

Rationale for Reserves

Holding funds in reserve is a method widely used by insurance companies as a hedge against adverse cost variation. Should a deficit occur in a given plan, reserves may be drawn down to cover costs until premiums can be adjusted in the subsequent contract year. Also, in the event that a plan involuntarily terminates with a deficit--in the case of bankruptcy for example--reserves help the participating carrier meet its contractual obligations to enrollees. Although carriers serve as claims-processing

agents on behalf of the federal government, they do bear an ultimate financial responsibility--and risk--in the event of plan termination. 7/

Reserves are not the only way to provide for adverse cost variation in FEHB. Another approach, which would require a change in authorizing legislation, would be to make available short-term borrowing from the U.S. Treasury. Treasury advances, subject to appropriate limits, could be simpler than the current system and cheaper for enrollees, because they might obviate the need for premium add-ons to perpetuate large reserves. Such a borrowing plan could be coupled with some minimal reserve level to help cover claims when a plan terminates with a deficit. Without such a resource, some organizations might be unwilling to continue participating in the FEHB program. Also, maintaining some reserve would provide an immediate source of contingency funds that could allay carriers' doubts about the timely availability of Treasury advances.

Contingency Reserves. As authorized by law, the OPM holds separate contingency reserves for each participating organization. The total cumulative contingency reserve designated for each carrier equals one month's premium income, or 8.3 percent of annual income. For 1980, contingency reserves for all plans totaled an estimated \$402 million, with about \$261 million (65 percent) earmarked for the two largest plans, Blue Cross/Blue Shield and Aetna. Contingency reserves accumulate primarily as a result of the 3 percent add-on to premiums paid by program participants.

7/ The consequences of plans' terminating with deficits would vary. Should the two carriers offering government-wide plans voluntarily quit the federal program with a deficit, both special and contingency reserves would be available to settle claims. Other carriers have access to special reserves only. In the event that available reserves were inadequate to cover contractual obligations, some would rely on other organizational resources, some would call upon reinsurers that underwrite their program, and some would have to rely on assessments to members or other measures.

TABLE 1. GROWTH OF FEHB RESERVES: CALENDAR YEARS 1971-1980

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Reserve Levels in Millions of Dollars										
Blue Cross/ Blue Shield and Aetna	100	211	178	196	112	315	428	595	530	368
Other plans	<u>26</u>	<u>40</u>	<u>60</u>	<u>68</u>	<u>72</u>	<u>97</u>	<u>140</u>	<u>197</u>	<u>206</u>	<u>122</u>
Total	126	251	238	264	184	412	568	792	736	490

SOURCE: Annual Statistical Publications of the Office of Personnel Management, 1972-1980.

NOTES: Reserves are reported for the end of each contract year.
Reserves of community-based plans are not included.

TABLE 2. COST ESTIMATES FOR GOVERNMENT-WIDE FEHB PLANS: CALENDAR YEARS 1976-1980

	1976	1977	1978	1979	1980	Aggregate Average
Blue Cross/ Blue Shield	7.8	8.5	1.4	2.4	-11.6 <u>a/</u>	1.7
Aetna	<u>15.4</u>	<u>6.2</u>	<u>3.6</u>	<u>3.6</u>	<u>-1.9</u> <u>a/</u>	<u>5.4</u>
Average <u>b/</u>	11.1	7.5	2.4	2.9	-7.3 <u>a/</u>	3.3

SOURCES: Derived by the CBO from OPM rate recommendation letters and from accounting statements of participating carriers.

a/ Minus indicates underestimate.

b/ The average is weighted to reflect the relative size of each plan based on their respective premium income.

Payments from contingency reserves are advanced to participating carriers both on an annual basis, according to a prescribed formula 8/, and on an ad hoc basis at the discretion of the OPM.

Special Reserves. Pursuant to agreements with the OPM, carriers hold special reserves that represent the excess of income over outgo, measured on an accrued basis. 9/ For the FEHB program as a whole, the targets for accumulation of special reserves represent about three-quarters of a month's premium income, or about 6.0 percent of annual income. The target amounts for specific plans vary from 4.2 to 12.5 percent of annual income, depending mainly on plan size. Smaller plans and those underwritten by the carriers themselves are generally thought to require larger reserves because of the greater chance of estimating error and the more limited resources available to pay claims in the event of plan termination. For 1980, special reserves held by all participating insurers combined totaled \$88 million, with some insurers showing a negative balance. The two largest plans held special reserves totaling \$107 million.

Reserve Growth

Total FEHB reserves grew almost steadily during the 1970s. Accumulated levels have declined since 1978, but the current reserves of \$490 million still represent about four times the 1971 level (see Table 1). Reserves for Blue Cross/Blue Shield and Aetna increased by \$256 million from the end of 1975 through 1980, representing about 85 percent of the growth of total FEHB reserves in that period.

Examination of recent experience for the two government-wide plans suggests that most reserve growth above existing targets occurred because of cautious cost estimating by OPM. A comparison of estimated and actual costs for the two government-wide plans shows overestimating in four out of five of the most recent years--averaging 3.3 percent over the 1976-1980 period (see Table 2).

8/ According to the current OPM formula, contingency reserve funds in excess of one month's premium income are advanced to participating carriers so long as the reserves the carriers hold do not exceed five months' premium income.

9/ The accounting for participating carriers uses an accrual rather than cash basis; that is, costs are recorded as they are incurred rather than as they are paid.